UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
WASHINGTON 25, D.C.

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PENALTY FOR PRIVATE USE
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Cooperative Research and Service Division

November 8, 1952

IMPORTANT NOTICE
FOR FARMERS' MARKETING AND PURCHASING ASSOCIATIONS

Re: Proposed Regulations to Govern Income Tax Treatment of Exempt Cooperatives, and of the Patrons of All Cooperatives.

SUPPLEMENT NO. 2 TO MISCELLANEOUS REPORT 156

"RECENT FEDERAL INCOME TAX CHANGES AFFECTING COOPERATIVES"
(Issued in October 1951)

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Supplement No. 1 (Revised, June 4, 1952) reported an amendment to Income Tax Regulations 111 by the Commissioner of Internal Revenue. This covered the reporting of certain patronage dividends to the Commissioner annually on Information Returns (Internal Revenue Forms 1096 and 1099). Affected by that amendment were all kinds of cooperatives, including farmers' associations which are exempt from Federal income taxation, as well as those not so exempt (but excluding rural electrification cooperatives and certain mutual insurance companies).

Supplement No. 2 here reports a proposal by the Commissioner of Internal Revenue to further amend Regulations 111 concerning administrative details of the income tax treatment of exempt cooperatives, and of the patrons of all cooperatives.

A complete copy of the Commissioner's proposal, as it appeared in the Federal Register for November 8, 1952, is reproduced herein. The management of all farmers' marketing and purchasing associations should take notice of the following points:

1. The proposal is subject to change before final adoption. The Commissioner will give consideration to any data, views, or arguments pertaining to this proposal which are submitted to him in writing in duplicate before December 9, 1952. The address is Commissioner of Internal Revenue, Washington 25, D.C.

2. The main part of the proposal affects only the farmers' marketing and purchasing associations which are exempt under Section 101(12) of the Internal Revenue Code.

3. Included, however, is a proposed amendment of Section 29.22 of the Regulations which outlines factors in the taxability of patronage dividends, rebates, or refunds in the hands of the patrons of cooperative associations. This applies to the patrons of all cooperatives, whether tax-exempt or not.

Sometime after December 9, 1952, a revised Supplement No. 2 will be issued containing comments on the regulations as finally adopted by the Commissioner of Internal Revenue. Such comments will be designed to assist cooperatives and their patrons in a proper observance of the tax laws and regulations.

EXCERPT FROM FEDERAL REGISTER OF NOVEMBER 8, 1952

PROPOSED RULE MAKING

DEPARTMENT OF THE TREASURY

Bureau of Internal Revenue

[26 CFR Part 29]

INCOME TAX TREATMENT OF EXEMPT COOPERATIVES FOR TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1951

NOTICE OF PROPOSED RULE MAKING

Notice is hereby given, pursuant to the Administrative Procedure Act, approved June 11, 1946, that the regulations set forth in tentative form below are proposed to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury. Prior to the final adoption of such regulations, consideration will be given to any data, views, or arguments pertaining thereto which are submitted in writing in duplicate to the Commissioner of Internal Revenue, Washington 25, D. C., within the period of 30 days from the date of publication of this notice in the FEDERAL REGISTER. The proposed regulations are to be issued under the authority contained in section 62 of the Internal Revenue Code (53 Stat. 32; 26 U. S. C. 62).

[SEAL] JOHN B. DUNLAP,
Commissioner of Internal Revenue.

In order to conform Regulations 111 (26 CFR Part 29) to section 314 (a), (b), and (d) of the Revenue Act of 1951, approved October 20, 1951, such regulations are hereby amended as follows:

PARAGRAPH 1. There is inserted immediately preceding § 29.101 (12)-1 (26 CFR 29.101 (12)-1) the following:

SEC. 314. INCOME TAX TREATMENT OF EXEMPT COOPERATIVES (REVENUE ACT OF 1951, APPROVED OCTOBER 20, 1951).

(a) *Amendment of section 101 (12)*. Section 101 (12) is hereby amended as follows:

(1) By inserting after "(12)" the following: "(A)".

(2) By inserting after such paragraph the following:

(B) An organization exempt from taxation under the provisions of subparagraph (A) shall be subject to the taxes imposed by sections 13 and 15, or section 117 (c) (1), except that in computing the net income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under section 23)—

(i) Amounts paid as dividends during the taxable year upon its capital stock, and

(ii) Amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. Allocations made after the close of the taxable year and on or before the fifteenth day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent the allocations are attributable to income derived before the close of such year.

Patronage dividends, refunds, and rebates to patrons with respect to their patronage in the same or preceding years (whether paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount of such dividend, refund, or rebate) shall be taken into account in computing net income in the same manner as in the case of a cooperative organization not exempt under subparagraph (A). Such dividends, refunds, and rebates made after the close of the taxable year and on or before the 15th day of the ninth month following the close of such year shall be considered as made on the last day of such taxable year to the extent the dividends, refunds, or rebates, are attributable to patronage occurring before the close of such year.

(b) *Technical amendments.* (1) Section 101 is hereby amended by striking out "Except as provided in supplement U" and inserting in lieu thereof the following: "Except as provided in paragraph (12) (B) and in supplement U".

(2) The last sentence of section 101 is hereby amended by striking out "Notwithstanding supplement U" and inserting in lieu thereof "Notwithstanding paragraph (12) (B) and supplement U".

* * * * *

(d) *Effective date.* The amendments made by subsection (a) and (b) of this section shall be applicable only with respect to taxable years beginning after December 31, 1951 * * *

PAR. 2. There is inserted immediately following § 29.101 (12)-1 the following new sections:

§ 29.101 (12)-2 *Farmers' cooperative marketing and purchasing associations; taxable years beginning after December 31, 1951*—(a) *In general.* (1) For taxable years beginning after December 31, 1951, section 101 (12) is applicable to farmers, fruit growers', or like associations organized and operated on a cooperative basis in the manner prescribed in section 101 (12) (A). Although such an association is subject to both normal tax and surtax, as in the case of corporations generally, certain special rules for the computation of net income are provided in section 101 (12) (B) and § 29.101 (12)-3. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 101. Thus, under section 454 (a) such an association is not subject to the excess profits tax. Similarly, the provisions of section 26 (b), providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association subject to 101 (12) (B). The provisions of section 141, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts allocated as patronage dividends, rebates, or refunds are to be taken into account in computing the net income of such an association are set forth in § 29.101 (12)-4. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, rebates, or refunds see § 29.22 (a)-23.

(b) *Meaning of terms.* For purposes of §§ 29.101 (12)-2 to 29.101 (12)-4, inclusive, §§ 29.148-4, and 29.22 (a)-23, the following terms shall have the meaning ascribed below:

(1) *Cooperative association.* The term "cooperative association" includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons, except that the term does not include any cooperative or nonprofit corporation (including any cooperative or nonprofit corporation engaged in rural electrification) exempt from taxation under section 101 (10) or (11) or any corporation subject to a tax imposed by Supplement G (relating to insurance companies).

(2) *Patron.* The term "patron" includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

(3) *Allocation.* The term "allocation" includes distributions in cash or merchandise made by a cooperative association to a patron, the issuance by such association of capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or any other act by a cooperative association whereby there is disclosed to a patron the apportionment on the books of such association of the dollar amount of its assets for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative association, without disclosure to the patron is not an allocation.

(4) *Patronage dividends, rebates, and refunds.* The term "patronage dividend, rebate, or refund" includes any amount allocated (whether in cash, merchandise, capital stock, revolving fund certificate, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the

amount of such dividend, refund, or rebate) by a cooperative association, to the account of a patron on the basis of the business done with or for such patron. The following are not patronage dividends, rebates, or refunds:

(i) Amounts distributed in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents;

(ii) In the case of a cooperative association marketing the products of members or other patrons, the amount paid in cash or merchandise by the association for such products to the extent such amount is fixed without reference to the earnings of the cooperative association. For this purpose, the term "earnings" includes the excess of amounts retained by the association to cover expenses or other items over the amount of such expenses or other items.

§ 29.101 (12)-3 *Manner of taxation of cooperative associations subject to 101 (12)*—(a) *In general.* For taxable years beginning after December 31, 1951, farmers, fruit growers, or like associations, organized and operated in compliance with the requirements of section 101 (12) (A) and § 29.101 (12)-1 shall be subject to the taxes imposed by sections 13 and 15 or section 117 (c) (1), except that there shall be allowed as deductions from gross income, in addition to the other deductions allowable under section 23, certain special deductions provided in section 101 (12) (B) (i) and (c) below, section 101 (12) (B) (ii) and paragraph (d) of this section. Amounts allocated as patronage dividends, rebates, or refunds, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or other similar documents, with respect to patronage for the taxable year or for preceding taxable years, shall be taken into account in the manner provided in section 101 (12) (B) and in § 29.101 (12)-4.

(b) *Cooperative associations exempt from tax before January 1, 1952.* (1) In the case of a cooperative association exempt from tax for taxable years beginning prior to January 1, 1952, the taxable year (fiscal year or calendar year, as the case may be) shall be determined without regard to the fact that such association may have been exempt from tax during any prior period. See sections 41 and 48 and the regulations thereunder. Similarly in computing net income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 41, 42 and 43 and the regulations prescribed thereunder, whether or not the item arose during a taxable year beginning before, on, or after December 31, 1951. For the purpose of determining the method of accounting of the cooperative association under section 41, the method of accounting utilized in the return of such association filed for the first taxable year beginning after December 31, 1951, shall be deemed to constitute the method of accounting regularly employed by the cooperative association.

(2) For the purpose of computing, under section 122, the net operating loss deduction provided in section 23 (s), the terms "preceding taxable year" and "preceding taxable years", as used in section 122, shall not include any taxable year for which such association was not subject to the provisions of section 101 (12) (B). Thus, if the cooperative association was not subject to the provisions of 101 (12) (B) for the immediately preceding taxable year, the net operating loss is not a carry-back to any preceding taxable year, and the net operating loss carry-over to succeeding taxable years is not reduced by the net income for any preceding taxable year. No net operating loss carry-back or carry-over shall be allowed from a taxable year beginning prior to January 1, 1952. The adjustments to the cost or other basis of property provided in section 113 (b) and §§ 29.113 (b) (1)-1 to 29.113 (b) (1)-3, inclusive, are applicable although such an association was exempt from tax for taxable years beginning prior to January 1, 1952. Proper adjustment to basis must be made under section 113 (b) for the entire period since the acquisition of the property. Thus, adjustment to basis must be made for depreciation allowable for all prior taxable years although such an association was exempt from tax during such period. Similarly, in the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 125, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in § 29.113 (b)-1 (4) relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 125 in the same manner as if the institution were subject to tax from the date of acquisition of the bond.

(3) In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the institution was exempt from tax during such years) in which installment payments are received. Such adjustment shall be an amount which is equal to the proportion of the premium which each installment payment on principal bears to the face value of the mortgage loan. For the purpose of this adjustment, the term "premium" includes the amount of cash paid in excess of the face amount of the loan, including attorneys' fees, brokerage commissions, and all other costs directly attributable to the acquisition of the mortgage.

(4) The elective method of inventorying goods may be adopted by the cooperative association for any taxable year beginning after December 31, 1951, in accordance with the requirements of section 22 (d) and the regulations issued under that section. In order to use such method for such a taxable year, the cooperative association must exercise the election provided in section 22 (d) (2) (A) and § 29.22 (d)-3 even though it may have utilized such method for accounting purposes for taxable years beginning prior to January 1, 1952.

(5) The cooperative association may select either of the alternative methods for treating bad debts provided in § 29.23 (k)-1 (a) in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the approval of the Commissioner upon examination of the return. Any change in the method so selected and approved may be made only if permission is granted as provided in § 29.23 (k)-1 (a).

(c) *Deduction for dividends paid.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 101 (12) (A) and § 29.101 (12)-3, amounts paid as dividends during the taxable year upon the capital stock of the cooperative association. For the purpose of the preceding sentence, the term "capital stock" includes common stock (whether voting or nonvoting) preferred stock, capital retain certificates, revolving fund certificates, letters of advice, or other documentary evidence of a proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the shareholders of the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year. The determination of whether a dividend has been paid to the shareholder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation, in keeping its books, or upon the method of accounting upon the basis of which the net income of the corporation is computed. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see §29.27 (b)-2.

(d) *Deduction for income not derived from patronage.* There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 101 (12) (A) and § 29.101-(12)-1 amounts allocated during the taxable year to patrons with respect to its income not de-

rived from patronage (whether or not such income was derived during such taxable year) whether such amounts are paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. For this purpose, allocations made after the close of the taxable year and on or before the 15th day of the ninth month following the close of the taxable year shall be considered as made on the last day of such taxable year to the extent that such allocations are attributable to income derived during the taxable year or during years prior to the taxable year. As used in this paragraph, the term "income not derived from patronage" includes incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from temporary investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the value of the patrons' interest in such non-patronage income. Thus, if capital gains are realized from capital assets acquired and disposed of during the taxable year such income must be allocated to patrons of such year in proportion to the amount of business done by such patrons during the taxable year.

§ 29.101 (12)-4 *Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 101 (12) (B)*—(a) *General rule.* For taxable years beginning after December 31, 1951, patronage dividends, rebates, or refunds, allocated by a cooperative association entitled to tax treatment under section 101 (12) (B) to a patron shall be taken into account in computing the gross income of such association for the taxable year, as an increase in its cost of goods sold in the case of an association marketing products for patrons, or as a reduction in its gross receipts, in the case of an association purchasing supplies and equipment or performing services for patrons, as the case may be, if:

(1) The allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated, and

(2) The allocation, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or similar documents, is made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative association.

For the purpose of subparagraph (1) of this paragraph, amounts allocated by a cooperative association entitled to tax treatment under section 101 (12) (B) will be deemed allocated in fulfillment and satisfaction of a valid enforceable obligation, if made pursuant to provisions of the by-laws, articles of incorporation, or other contract, whereby the association is obligated to make such allocation after the retention of "reasonable reserves". Notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, amounts allocated as patronage dividends, rebates, or refunds during the taxable year, or on or before the 15th day of the ninth month following the close of such year, with respect to patronage for years preceding the taxable year, shall be taken into account as an increase in the cost of goods sold, or as a reduction in gross receipts for the taxable year, as the case may be, where retention as "reasonable reserves" of the amounts so allocated beyond the year in which earned was proper in accordance with the provisions of section 101 (12) and where the allocation is made to the patron to whose account the retained amount was apportioned on the books of the cooperative association.

(b) *Illustrations.*

Example 1. E, a cooperative association entitled to tax treatment under section 101 (12) (B), organized without capital stock, is engaged in the business of marketing products for its patrons on a non-pool basis. The by-laws of cooperative E provide that there shall be allocated to patrons as patronage dividends within a reasonable time following the close of the year all of the gross returns from sales, less expenses of operation for the year and amounts retained as "reasonable reserves" necessary to the operation of cooperative E. At the close of the taxable year, 1952, it is determined that from the gross returns from sales less operating expenses for such year, $5,000 is to be retained as "reasonable reserves" for various necessary purposes of cooperative E. It is assumed that the retention of such amount is proper in accordance with the provisions of section 101 (12). Such $5,000 is apportioned on the books of cooperative E to patrons of 1952 on a patronage basis. On March 1, 1953, pursuant to the terms of the by-laws $200,000, the balance of the gross returns for the taxable year, is allocated to patrons of 1952 on the basis of patronage. $100,000 of such $200,000 is allocated in cash. The remaining $100,000 is allocated in "retain certificates", bearing no interest and redeemable in the discretion of the Board of Directors of cooperative E.

There may be added to the cost of goods sold by cooperative E for 1952, $200,000 ($100,000 in cash, $100,000 in retain certificates), the total amount allocated as patronage dividends, rebates or refunds in fulfillment and satisfaction of the obligation of the by-laws, on March 1, 1953, before the 15th day of the ninth month following the close of 1952. There may not be added to the cost of goods sold by cooperative E for 1952, $5,000, the amount retained as reserves apportioned on the books, but not allocated as patronage dividends, rebates, or refunds.

Example 2. The facts are the same as example 1, it additionally appearing that at the close of 1953 it is determined by cooperative E to allocate as cash patronage dividends, rebates, or refunds to patrons of 1952, $5,000, the amount retained as "reasonable reserves" for 1952 and apportioned on the books of cooperative E to patrons of such year. On March 1, 1954, such amount is allocated.

There may be added to the cost of goods sold by cooperative E for 1953, $5,000, the amount allocated with respect to patronage of a preceding year, 1952, properly maintained as a reserve under section 101 (12) and previously apportioned to the account of patrons of cooperative E for 1952.

PAR. 3. There is inserted immediately after § 29.22 (a)-22 the following:

§ 29.22 (a)-23 *Patronage dividends, rebates, or refunds; treatment as to patrons*—(a) *In general.* Amounts allocated by a cooperative association, whether or not entitled to tax treatment under section 101 (12) (B), as patronage dividends, rebates, or refunds, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in other documentary form disclosing to the patron the dollar amount allocated shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section. The determination of the extent of taxability of such patronage dividends, rebates, or refunds is in no way dependent upon the method of accounting employed by the patron or upon the basis, cash, accrual or otherwise, upon which the net income of such patron is computed.

(b) *Extent of taxability.* (1) Patronage dividends allocated by a cooperative association to a patron with respect to products marketed for such patron, with respect to supplies, equipment, or services for the trade or business of such patron or with respect to supplies, equipment or services the cost of which was deductible by the patron under section 23, shall be included in the computation of the gross income of such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, letter of advice, retain certificates or similar documents:

(*a*) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated. For this purpose, it is immaterial whether such allocation was made within the time required by § 29.101 (12)-4 (a) (ii).

(*b*) To the extent of the face amount of such documents, if the allocation was made with respect to patronage of a year preceding the taxable year from amounts retained as "reasonable reserves" under § 29.101-4 (a).

(*c*) To the extent of the cash or merchandise received in redemption or satisfaction of such documents at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in subdivision (*a*) of this subparagraph or from amounts retained as "reasonable reserves" under § 29.101 (12)-4 (a), referred to in subdivision (*b*) of this subparagraph.

(2) Patronage dividends, rebates, or refunds allocated by a cooperative association with respect to supplies, equipment, or services not obtained for the trade or business of a patron or with respect to supplies, equipment, or services the cost of which was not deductible by the patron under section 23, are not includible in the computation of the gross income of such patron.

PAR. 4. Section 29.148-4 is amended by striking subparagraphs (1), (2), (3), and (4) of paragraph (d) thereof and inserting in lieu thereof the following: "The terms, 'cooperative association,' 'patron,' 'patronage dividends, rebates, and refunds,' and 'allocation' are defined, for the purpose of this section, in § 29.101 (12)-2 (b)."

[F. R. Doc. 52-12053; Filed, Nov. 7, 1952; 8:55 a. m.]